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ARTICLES: THE 411

International Business Income

Effective Communication is Essential

By Robert M. Swift, CPCU, CIPA, CBCP

Recently, I spent a month in the Middle East helping government agencies and private companies develop their disaster preparedness plans. You would think that of all places, they would be fully prepared for any disaster. Not so. In one country, the Contingency Coordinator for the Ministry of Finance was having trouble convincing the unit managers to participate in the development of their contingency plan. Therefore, we conducted a tabletop exercise for the Incident Command Committee. It was total chaos. Some managers wanted to know why they were there and some wanted to know who developed the plan. As a result, senior management realized the need to be serious about their Contingency Plan. It is disturbing that this scenario is typical worldwide. Governments and organizations are not adequately prepared.

According to several studies, 70% of businesses with major property damage go bankrupt after a catastrophe because they do not have a tested Contingency Plan and lack the proper financing to see them through their period of recovery. After suffering a loss, unprepared businesses lose millions of dollars and wonder, "Why didn't someone tell me?" We have been involved in numerous claims where the insured only received twenty to thirty percent of their loss because they did not understand their insurance policy.

about the author

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is a business interruption specialist with more than thirty years' experience worldwide in the insurance and risk management field, advising corporate executives about the benefits of properly preparing for disaster. Through his company, Business Interruption Consultants, Inc., he has developed a unique, Web-based business interruption resource, **www.BISimplified.com.** Swift is a regular continuing education provider for business professionals of all levels, and is in demand by numerous professional organizations as a frequent public speaker. He is a member of the CPCU Society, the Disaster Recovery Institute, the Risk and Insurance Management Society, the National Society of Insurance Premium Auditors, and a past member of the Insurance Institute of London.

Business Income is the most difficult and misunderstood coverage and the majority of business owners do not know how to calculate their exposure. As a result, they receive an education after the loss, which causes hard feelings and increases the probability of lawsuits. It is one of the most litigated insurance coverages in the United States.

Most executives are in denial that a disaster will happen to them. In the worst tsunami-affected country of Sumatra, the Indonesian General Insurance Association (AAUI) recently reported that the estimated total risk value of insurance policies covering earthquakes in Aceh and North Sumatra stood at Rp 16.8 trillion ($1.9 billion US). Only six percent of all insurance policies in the northern two provinces have acquired extra coverage against natural disasters according to Jasindo, one of the largest general insurance companies operating in the area.

As stated by AON Global, many businesses and hotels had no BI insurance, property insurance was inadequate as a stand-alone policy and of those hotels that did retain BI, many had limited cover due to inappropriate wording, sub-limits, etc. However, unlike the major international corporations that had some insurance, many small and medium businesses had none. Several of these businesses hit with the tsunami, floods, and earthquakes are out of business because they did not believe it would happen to them.

Many international businesses believe they will recover from a disaster in six months, even though they do not have a tested Contingency Plan and are aware it will require nine to twelve months to replace their machinery and equipment as well as rebuild their facilities. Interestingly enough, when asked how long their customers and suppliers will wait for them to resume operations, their confidence disappears and they say, "Four weeks." With their unrealistic six month recovery plan, they have grossly underestimated two of the most important contingencies. Their business would never survive.

At the same time, consideration must be given to the particular statutes of various countries. In Ireland, it is illegal to lay off employees after a disaster; England recently passed the Corporate Manslaughter Act where executive officers are criminally liable for bodily injury; and in the Middle East all companies are required to have at least fifty percent Arab ownership. Also, most business transactions completed in the Middle East are conducted through Arab brokers and intermediaries.

In the international market, insurance companies leave a lot of premium dollars on the table. Most experts say almost all commercial property policies are at least twenty percent undervalued. These companies do not help the situation by accepting what the insured tells them and then plant time bombs of exclusions and valuations in their policies. Where are the risk management/ loss control services that could so easily save organizations from extinction? The Association of British Insurers (ABI) issues a manual entitled, "Recommended Practices Wordings and Procedures Relating to Material Damage and Commercial and Industrial Insurance." Most insurers conducting business in the United Kingdom are members of this association and follow its recommendations. This body functions much the same way as the Insurance Services Office functions in the United States: As a clearinghouse for policy language that suggests what insurance policies should cover and defining terms for the insurance industry.

I believe the international business income coverage called "Loss of Profits" or "Business Interruption" actively forces businesses to over-insure their exposure. The Loss of Profits coverage pays for turnover (sales), less standing charges (cost of sales) which are considered discontinuing expenses. Some of these standing charges do not completely stop, so the claim calculation model is incorrect in that area. The Loss of Profits coverage is purchased in two parts: The limit of insurance (percent of turnover at risk) and the period of indemnity (recovery period). The common amount purchased is 100% of turnover with a twelve month recovery period. The interesting thing about buying 100% turnover is that it actually represents more like a two year business income limit, as the calculation is turnover minus standing charges or gross profit not sales.

Business Interruption policies pay for lost future income so the trending of the business is very important and the insurance buyer needs to look at their future gross profit as the business income amount to be insured, not their turnover. For example, a $10 million turnover and $5 million standing charge equals a $5 million gross profit. Therefore, twelve month's protection is $5 million, not $10 million and a fifty percent turnover would carry them through twelve months of recovery. As for the recovery period, sometimes a partial loss takes longer than a total loss. If they chose a twelve month indemnity, and the partial loss takes fifteen months, the last three month's loss would not be covered even though there is plenty of limit left on the policy.

Also, there is the "extra expense" component which is actually "expenses to reduce loss" coverage. If they spend ten dollars extra, they must prove they reduced the loss by ten dollars.

Standing Charges (discontinuing expenses, as in cost of sales) deducted in the accountant's claim models are sometimes in error because they take percentage deductions instead of actual deductions. The fundamental question is would these charges, in whatever category they fall, change in relation to turnover? Sales might be made up later, but there will still be continuing costs.

According to the Loss of Profits policy, there has to be physical damage to the described premises from a covered peril that interrupts operations and causes a loss of income. However, not all physical damage causes a loss of income. For example, if a warehouse storage facility burns and is destroyed, they might still operate the business from the production line or another warehouse and make "sales," which means there was no business interruption. The business interruption loss period starts with the disaster and continues until operations are where they should be had there been no loss. Loss reduction expenses (extra expenses) are additional expenses used to quickly reach and maintain expected sales while the facilities are repaired or replaced.

For every insured, a business income report (appraisal) should be completed by a business interruption surveyor. One of the difficult aspects that the report attempts to address is to estimate the maximum loss sustained by the operating company. In the context of underwriting, the information from the report enables the underwriter to consider a rate and premium calculation for the risk related to the amount of the coverage which the underwriter is prepared to return for his own account, and/or receive and cede to reinsurers. The interruption report is also valuable to the claim adjuster or claims official investigating the post damage situation when a potential loss of profit is to be considered, as it makes available information established before the disaster and provides a structure for discussion about the best procedure to minimize the possible loss of gross profit.

With increasing competition and demand for more agency services, it is essential for brokers worldwide to communicate with their customers throughout the year, not just at renewal. Businesses get into trouble because they have not read their insurance policy and so are not aware of their rights, duties, or what is or is not covered. Left alone, executives will make their own assumptions about policy language.

The time for clarification is before a disaster. Business owners must assume responsibility for their own risk management programs to ensure they are adequately prepared for the worst case scenario. This preparation includes plugging gaps in coverage, completing a disaster preparedness plan, accurately calculating their financial risk, and knowing how to present their BI claim. A little effort in communication with the insured will go a long way to increasing everyone's profitability.

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